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Kamminga, Y.P.

### ***published in***

Revue d'arbitrage et de médiation / Journal of Arbitration and Mediation  
2016

### ***document version***

Early version, also known as pre-print

[Link to publication in VU Research Portal](#)

### ***citation for published version (APA)***

Kamminga, Y. P. (2016). Designing differently: conflict and the challenge of addressing tensions between contractual and non-contractual norms. *Revue d'arbitrage et de médiation / Journal of Arbitration and Mediation*, 6(1), 9.

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# DESIGNING DIFFERENTLY: CONFLICT AND THE CHALLENGE OF ADDRESSING TENSIONS BETWEEN CONTRACTUAL AND NON-CONTRACTUAL NORMS

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## ABSTRACT

Lawyers are the engineers and architects of contractual frameworks. Arguably, with respect to the success of the undertaking, they occupy a place of equal importance to the parties executing the contracts. After all, contracts are put in place to help prevent problems from arising in long-term business relations. As studies of business interactions show time and again, and I have discussed in earlier articles, keeping conflict at bay in long-term business relations is not an easy task. Many are still perplexed to learn what the research consistently indicates: that contracts themselves are partly responsible for the tensions that arise. In fact, contracts seem to do little to preserve relationships; instead, they tend to fuel disputes and trigger costly litigation.

What are the factors that underlie this common failure of contracts? It appears that contract drafters ignore non-contractual norms when designing contracts, which leads to tension during the contractual relationship. In earlier work I identified a number of non-contractual factors that influence parties' actions but rarely find a place in contracts (Kamminga 2008; 2011). These non-contractual drivers influence contract parties' behavior and can, in fact, encourage parties to act contrary to what the contract text directs them to do. This article takes a problem solving approach: it studies the dynamic between various drivers of contractual behavior more in-depth, and looks into the drivers triggering or impeding evolution in contract design. I discuss why and how lawyers may better manage tensions and prevent disputes by revising their contract design methods and choices (and how to convince them to do so).

What follows is a discussion of the dynamic interplay between the formal and informal governance mechanisms at work in every long-term relationship. In addressing this matter, this paper points out (a) why lawyers experience very little incentive to search for ways to improve the cooperation function of contracts; (b) how to overcome these obstacles; and (c) how to integrate social and economic drivers to increase the effectiveness of contracts. To this end, a framework is put forward that might be used to (1) identify tensions between formal and informal gover-

nance structures in actual contracts and (2) provide a roadmap for contract design that foreshadows and possibly eliminates some of these tensions during the contract drafting process. This article aims to contribute to a broader discussion of more effective ways in which transaction lawyers can contribute to society and, more specifically, the paper explores how a more holistic approach to contract design may help prevent conflict and achieve better results for contract parties.

## INTRODUCTION

Our contractual relations are governed by a variety of norms and rules. The laws to which we are subject, the economic interests we hold, the social rules that govern our society, the nuances unique to each interaction, and elements that we invent as we go along all comprise these norms and rules. Together, they determine how we interact and cooperate. At the core of the network of formal and informal governance mechanisms are the arrangements between the main parties laid down in contracts. This core is what lawyers and many parties tend to focus on, almost exclusively, when negotiating and enforcing contracts.

The flaw that so often undermines contracts is that they do not seem up to the task of dealing with the complexities of today's long term contractual relationships. Frequently, contract documents are unable to help parties get the process related to their collaboration back on track. Not only do written agreements routinely fail to keep parties on course when they have a disagreement, contracts themselves are often suspected and identified as the cause of problems. It appears that their active use as governance instruments may increase the chances of a breakdown of cooperation. There is ample evidence to confirm that instead of functioning as guideposts for the contract parties, the ideal represented in contract literature, contracts, in practice, often disrupt the collaboration process and undermine the contractual relationship.

Empirical research reinforces this negative view of contracts. Studies show that parties are not fond of contracts as tools for keeping their cooperation on track (Passera *et al.* 2013). Some studies even suggest that complex contracts are alienating those that could make them a success (Malhotra 2012). When contract managers are asked about their experience with construction contracts, they often identify them as inadequate and as the starting point for disagreements. What they are missing is clear guidance for dealing with the consequences of, for instance, unexpected events or changes (Stephenson 1996: 11; Kamminga 2008). Whenever unexpected circumstances arise, initially, parties tend to dig in; they either hide behind the contract or point at lacu-

nae in the agreement. A supplier may use the contract as justification for change orders as they are asked to act in ways not specified in the contract. The purchaser, at the same time, may try to use that same contract to enforce penalties triggered by delays to the schedules as a result of discussion about whether change orders are justified. In this particular context, vague or punitive contract language can create an adversarial dynamic; it often fuels disputes that can lead to costly and uncertain litigation (Triantis 2013).

For those parties that try to maintain a collaborative atmosphere, the contract is of little use, and such parties rely on alternatives. Mostly, other informal mechanisms are used such as reputation or reciprocity. They are the main drivers in parties' dealings with each other (Macaulay 1963; Malhotra, 2012). However, these mechanisms only suffice as long as parties are able to resolve issues using the applicable non-contractual norms. As soon as differences of opinion arise that compel parties to take legal positions, non-contractual mechanisms fail and all that parties are left with is the contract. This slide toward conflict creates an uncomfortable situation because what is essential for the success of any long-term contractual relation – how parties will collaboratively achieve their goals – is not given a solid structure in contracting and contracts.

An interesting paradox has become evident. Our goal with contracts – at least in most Western countries – is to ensure that the other party will actually do what was initially promised, yet seem disinclined to carefully study what drives these parties apart and disrupts their contractual arrangements.<sup>1</sup> As a result of this gap in our inquiry, contract parties continue to be exposed to myriad, disruptive forces that contracts fail to address. These unexamined forces often have the capacity to undermine the chance of parties actually having a successful contractual relationship.

The remainder of this article discusses key factors that determine parties' contractual behavior. The objective is to further clarify how ignoring these forces at play in contracts may be harmful. The article will then analyze what possible avenues can be explored to design contracts that better cater to parties that want contracts to serve as guideposts for the cooperation process.

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1. There are of course other economic mechanisms at work in a sector that make parties live up to promises that are not specified in the contract, such as reputation mechanisms or a strong sense of obedience to social norms, but these not always apply or have the expected result, see Bernstein 2001, and Elickson 1991.

Part I briefly discusses the purpose of contracts in contract design literature and identifies the key role of contracts as studied in empirical research, as well as the problems that impact contracts as cooperation mechanisms. I will further outline how by disregarding the economic and social force-field in which parties operate most current contracting practices fail to furnish parties with the guidance required to manage the ups and downs of complex long-term contractual relations. It then goes on to argue why contract literature teaches us little about facilitating cooperation and how lawyers experience little incentive to design cooperative contracts. Part II highlights what we can learn from scholars studying contractual behavior and how contracts and other drivers influence contract party behavior. To that end, I discuss some of the drivers that influence contract parties' behavior within their contractual dealings. Part III calls for a revisited contract design strategy, one that facilitates cooperation through contracts. I examine what lawyers, as designers of contracts, may do differently to improve contracts. I explore how, by using the insights from Part II, contracts could be designed more effectively by seriously considering the dynamic interrelationship between contractual arrangements and other non-formal mechanisms. The lessons drawn from this approach may offer some footholds for lawyers looking for ways to devise contracts that empower parties to understand and anticipate the forces that drive contractual relations. The approach enables the design contracts that better harness those forces through paying particular attention to the interaction between the norms set forth in contracts and other non-legal norms that drive contract behavior. Part IV points out possible obstacles for effective implementation and presents ways in which they may be overcome.

## **I. LITERATURE REVIEW**

To set the stage for a discussion of the incentives lawyers experience when designing contracts, I briefly introduce the main forces at work. This part discusses the reasons we enter into contracts in the first place. It explores the directions provided to contract drafters by contract law and practice, contract literature and our legal education. It also explains why the current structure hardly incentivizes lawyers to devise contracts that facilitate cooperation.

### **A. Interdisciplinary views of contracts function and cooperation**

Contracts are valued as essential governance structures, indispensable in facilitating cooperation in contractual relations. Contract researchers and practitioners alike, however, tend to focus on control



and enforcement in order to guarantee cooperation. They often fail to consider strategies as a means of actively nurturing cooperative behavior (Passera *et al.* 2013; Malhotra & Lumineau 2011).

The legal and economic branches of contract (design) literature have rather limited views of the purpose of contracts. The legal perspective on the purpose of contracts focuses almost uniquely on enforceability – a contract allows a party to go to court and impose on the other party what was agreed and thereby prevent contractual breach.<sup>2</sup> From this perspective, the contract occupies the role of tool or, more accurately, weapon. Its serves one party against the other; it does not reconcile parties and shepherd them in the direction of mutual benefit or shared goals.

Economists take a somewhat broader perspective. They view contracts as tools that allow for the operation of the market as well as the allocation of risk. Basically, contracts help people to rely on promises made by others, the performance of which lies in the future (Triantis 2000; Posner 2001; Shavell 2004). Some economists along with management scholars regard contracts as also having an information function. In this view, contracts have a function as a resource, a document in which parties lay down what they originally agreed upon so that they may consult the document later (Shavell 2004).

Only a few economic and legal scholars mention that contracts also function as a framework that governs the relationship between the two organizations (firms) (Gulati 1995; Oxley 1997; Ryall & Sampson 2003; MacNeil 1999). A small area of empirical economic literature suggests that contracts describe what the collaboration process between parties should look like.<sup>3</sup> Inspired by studies in practice, they argue that contracts may be drafted as frameworks that go beyond purely *legal* documents.<sup>4</sup> This view suggests that contracts may be «blueprints for exchange» and a means to plan the collaboration. It further intimates that contracts may serve to set the expectations of all partners involved and consequently reduce misunderstandings and costly missteps (Kamminga 2008; 2015).

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2. Courts seem to reinforce this (Gilson *et al.* 2013).

3. Macaulay (1963) is the first – and still influential – empirical study of contracts and relationships in businesses. He deals with the question when contracts are necessary (when terms of agreements were complex, when repeat dealings were unlikely, when the size or organization of the firm meant that employee who executed the deal needed a formal vehicle to communicate its terms to other members of the firm).

4. See Ryall and Sampson (2003: 4) (doing empirical research on over 40 technology alliances).

The angle taken by most contract theorists is, however, to look at contracts solely as mechanisms that incentivize people to cooperate solely by means of the threat of enforcement, i.e. the contract as a weapon. Traditional contract theory focuses on incentivizing parties to follow through on promises, mainly by using formal mechanisms (such as written contracts). Much of legal contract scholarship focuses on contracts as *formal* enforcement mechanisms – enforceability being the incentive for parties to voluntarily live up to the contract, or ‘cooperate.’ Relational contract theorists also tend to discuss cooperation as a result of enforcing promises. The factor differentiating the relational theory with traditional contract theory is that these scholars primarily focus on the non-contractual concerns for maintaining the relationship. They focus on studying the *informal* mechanisms that incentivize contract parties to refrain from contractual breach (Macaulay 1963; MacNeil 1980; 1999). All of these are tools that allow for private sanctions, which keep breach of promises at bay (Gilson *et al.* 2010). Examples of informal contracting mechanisms that have a strong enforcement aspect are tit-for-tat strategies (Axelrod 1986), or social norms type mechanisms such as reputation, and reciprocity mechanisms that incentivize people to act cooperatively as opposed to pure self interest driven behavior.

The empirical management literature also finds that contracts strongly focus on enforcement. It divides contract terms between those that have either a control function and those that serve a coordination function (Furlotti & Grandori 2010; Malhotra & Lumineau 2011). Coordination clauses cover the division of tasks and responsibilities; they are meant to enhance monitoring and coordination. Control clauses are about mitigating risks of opportunism and typically include decision and termination rights (Schepker *et al.* 2014). Furlotti *et al.* find that most of the terms in contracts have a control function. It appears that the majority of contracts utilize very few coordination type terms that facilitate the cooperation process. In general, contract drafters tend to spend most of their time and effort on making the contract an effective control and enforcement tool. This approach develops a document that anticipates conflict and is intended to be wielded protectively or offensively by one party against the other. This preparation for failure is the very spirit of the contract, not facilitating and sustaining a cooperative relationship that moves parties toward the goals that necessitated the contract in the first place.

Organizing cooperation is mostly done by informal rather than by formal governance mechanisms. The only real reference to cooperative behavior one can commonly find in contracts is a ‘good faith’ provision that provides broad standards of appropriate behavior in contracts

(Reiter 1983; Thomas 2012). What these provisions mean is subject to interpretation, which makes them hard to enforce. Empirical researchers have found that some firms, however, do include contractual terms that are hard to enforce legally (Gulati 1995; Oxley 1997; Sampson 2003; Ryall & Sampson 2003). An advantage of this approach is that it not only helps parties in their relationship but, as a legal document, it also provides guidance to the courts on the partner intentions, should their process of collaboration break down. It helps a judge or other neutral party to understand the context in which to interpret the terms of a contract and the parties' actions should a case be brought before him (Gilson *et al.* 2012).

The fact that limited attention is paid to cooperation in contract design triggers debate outside the legal world but not so much in mainstream contract literature. Until now, the legal and economic literature that addresses the limits of complex contracts has remained focused primarily on traditional subjects and how courts deal with legal concepts, consequences of contractual incompleteness, and problems resulting from differences in interpretation (Gilson *et al.* 2014). Relational theorists have taken an opposite approach. They have mostly stressed the importance of informal governance mechanisms in organizing the parties' cooperation process. In neither of these main branches in contract literature has much attention been paid to how contracts can go or perhaps should go beyond their traditional role as enforcement mechanisms and take the responsibility of actively facilitating and streamlining cooperation – in other words, making contracts better at *inviting* cooperative behavior.

Yet, other disciplines have hinted at it. Some have signaled the poor track record of contracts and identified the absence of flexibility as a problem that generates tension (Malhotra 2012). Contracts that neglect the facilitation of inter-party cooperation establish a tension that is driven by rigidity of contracts, on the one hand, and the need for flexibility in doing business. Flexibility is considered necessary particularly in cases where non-routine tasks are frequently organized into projects. Infrastructure projects may be the ultimate example.<sup>5</sup> Management and organization studies research shows that formalization is quite generally believed to be in contrast with flexibility and innovation, often frustrating adaptability (Furlotti & Grandori 2010). Under conditions where high degrees of uncertainty prevail, contracts are considered to be inadequate. The costs of writing and enforcing contracts is substantial

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5. Flexibility refers to the reconfiguration capacity of a system in the face of changing and unforeseeable circumstances (Piore and Sabel 1984; Volberda 1998).

whereas the parties can be affected in unpredictable ways by countless contingencies that traditional contracts cannot resolve (Williamson 1979).

Empirical studies into the effects of contracts confirm this negative picture. Initial findings suggested contracts were almost by default harmful, although more recently this literature has started to nuance its negative image of contracts (Goo, Kishore, Rao, & Nam, 2009). Originally contracts were considered not only inadequate but even detrimental and undermining other governance mechanisms. Formal contracting was seen as weakening relational arrangements by signaling distrust or non-expectance of reciprocity, which in turn motivates opportunism (Ghoshal & Moran, 1996; Macaulay, 1963). Similarly, the presence of relational arrangements was considered to marginalize costly and inflexible formal contracting (Dyer 1997; Macaulay 1963; Macneil 1980; Zajac & Olsen 1993).

Yet, more recently, a growing body of theoretical and empirical work sees possibilities for contracts as cooperation tools. Some suggest that relational and contractual mechanisms not only coexist but also enable and complement each other (Goo, Kishore, Rao, & Nam, 2009; Luo, 2002; Poppo & Zenger, 2002; Ryall & Sampson 2009). This research suggests that firms are unwilling to engage in incomplete contracts in the absence of relational norms and trust (Lorenz, 1999; Poppo & Zenger 2002). Concurrently, contracting reinforces informal arrangements by establishing the norms of collaboration and enriching partners' understanding of each other's assumptions, expectations, and business processes (Luo, 2002; Ryall & Sampson, 2009). In other words, contracts are not inherently harmful but can, if well designed, directly or indirectly lead to cooperation in the context of other governance structures.

The need for a wider governance structure to support the commitment to cooperative behavior seems paramount. Empirical studies of large construction projects indicate that commitment at the organizational level and contractual procedures or non-contractual norms are essential (Nystrom 2005). The lack of that support is a serious threat to cooperation success (Stephenson 1996 and Barlow *et al.* 2003). Threats to establishing cooperation originate in different areas. Some emerge in the implementation of the concepts in an organization; others in the legal uncertainty these forms create, and some arise in the margins set by, for instance, procurement laws. These threats together may frustrate the early implementation of relational contracting (Kamminga 2008; Triantis 2013).

Abstract notions of cooperation that are not well embedded in contracts can cause misunderstandings on an organizational and legal level. Often, these notions are different from the terms used in more traditional contracts. If the concepts are not translated into legally enforceable terms, implementation can lead to legal disputes regarding intended meaning. Barlow *et al.* note: «(T)he difficulty is that there is little common ground between a fully-fledged partnering agreement, which embodies notions of good faith, and a traditional style contract, which preserves the self-interest of each party» (Jones 2003). Contracts mostly deal with remedies and penalties for noncompliance. Enforcement of cooperation principles is also considered to be a problem (Cox and Thompson 1996). From a contractual point of view, a cooperative contract may, in some cases, be considered non-binding or too vague to be enforceable (Van den Berg & Kamminga 2006).

In short, current contracts are still predominantly focused on their control and not so much on their coordination (or cooperation) function, which leads to problems in contracting practice. But there is reason for optimism. The good news is that recent studies indicate that contracts do have the potential to become better cooperation mechanisms. Empirical scholars have found that formal and informal governance mechanisms can strengthen each other. They have identified a number of contracting directions in practice that in fact integrate both formal and informal governance mechanisms (Gilson *et al.* 2010). However, to move from isolated attempts to make cooperation part of contractual governance towards a truly integrated contract design approach that fosters cooperation, and eventually contract design theory that embraces the non-contractual mechanisms, the lawyers as drafters of contracts, need to be onboard. Lawyers' attitude towards this type of contract innovation is likely to be pivotal for the development of cooperation in contract law. To get a better sense of whether current frameworks will make them favorable to such changes, I next turn to the main drivers likely to influence a legal professional drafting behavior.

## **B. Lawyers as Designers of Contracts**

What about lawyers and the extent to which they are focused on developing cooperative governance structures? Despite the fact that cooperation breakdowns have arisen for years, there has been very little innovation in contracts aimed at mitigating this flaw (Triantis 2013). Research shows that in some industries parties are desperately looking for new ways to collaborate more effectively and safeguard against disruptions of their business relations by innovating the ways in which they

cooperate (Gilson *et al.* 2010). Yet, contracts do not seem to integrate these trends. Lawyers still tend to focus on writing contracts to enforce promises and manage risks with very little devoted to the role of contracts as facilitators of cooperation. In fact, contract drafters tend to actively *refrain* from designing contracts that are attuned to the necessity of pro-actively encouraging cooperation, as these terms have no real legal meaning. Apparently, lawyers, as contract-designers, are not incentivized to make contracts the optimal cooperation platforms in the sense discussed above. Thus, governance structures that facilitate cooperative behavior do not automatically emanate from the common frames of reference applied by lawyers. If that were the case, legal professionals would be naturally encouraged to add more cooperative terms in contracts. If no one specifically asks lawyers to integrate them into contracts, non-contractual mechanisms, it is safe to assume, will be largely ignored.

First, no one can deny that the lawyer's role in contracting is an important one. Transactional lawyers are often responsible for the type and language of the contract. Most business negotiations eventually involve lawyers, and if a deal results, the outcome is translated into contracts. The lawyer's role in these deals entails either drafting or revising an agreement, (re-)negotiating the conditions of an existing agreement, or resolving a conflict that arose during the contractual relationship (Kamminga 2011; Triantis 2013). They may not be the decision makers where the content of the business deal is concerned, but as designers of contracts, lawyers have an important say in the legal agreement's look and feel. Thus, analyzing the incentives at play in the drafting contracts and hammering out the language can help us understand why most agreements feature very little language that is focused on facilitating cooperation.

Lawyers serve as both the designers and interpreters of contracts. Two types of lawyers divide up these tasks – those who work on transactions and those who specialize in litigation. The role of the first group of lawyers is – among others – the (re)negotiation and drafting of contracts. This is the group we focus on here; these are the lawyers who design contracts.

Understanding the frame of reference that transactional lawyers apply when making contract design decisions gives us insight into their decisions regarding the exact terms and language they choose or negotiate. I distinguish among four types of rules lawyers are bound by or take as guidance.

The first three important sets of rules that one may assume influence a lawyer's decision making are ethical rules of behavior, the rules of contract law, and the directions provided by the literature on contracts and lawyers' roles in drafting. Comprising the fourth of these 'rules', the lawyer's own personal views will direct him in his drafting work, informing what a contract should entail and how he defines his role in its development. Together, these four rules or norm sets tend to drive the lawyers in their contract design.

The first and most important set of guidelines followed by lawyers are the ethical rules. In the literature, a lawyer's professional responsibility in negotiating contracts has been loosely typified as fulfilling the role of advocate, educator, wordsmith, and scribe (Duhl 2010). The ABA Model Rules of Professional Conduct provide lawyers – with significant leeway – some concrete direction in fulfilling their ethical obligations with respect to drafting and negotiating contracts (Menkel Meadow 1999; Salbu 1995; Stark 2007). It basically stipulates a duty to facilitate exchange and promote trust, and underscore that promises will be enforceable. Based on these rules, lawyers have duties to their own clients in the drafting process, protecting them from fraud and discouraging them from engaging in reckless behavior.<sup>6</sup> The transactional lawyer should avoid ambiguous or vague language and identify ambiguity in contracts drafted by the other side. All in all, these ethical rules furnish lawyers with significant freedom in their design. Despite the duty to facilitate exchange and promote trust, lawyers seem to focus most on the last criterion, making sure that promises will be enforceable.

A second baseline principle in contract design can be derived from statutes and common law. In terms of what lawyers have to deliver when drafting and forming contracts, only the basics are provided for. The contract includes the primary components for contract formation: offer and acceptance, consideration and the essential terms such as parties, quantity, date of delivery and payment terms, and statutory and judicial interpretations of key terms. A drafter also has to prevent including conflicting terms concerning material items.<sup>7</sup> Adding to this, some contracts are illegal or unenforceable. For instance, when they involve an agree-

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6. Duhl distinguishes three situations: (a) the lawyer who knowingly or recklessly drafts false representations; (b) fraud, conscious ambiguity, and errors in transcription by the lawyer or opposing lawyer; and (c) the lawyer who knowingly drafts an invalid contract provision.

7. *Roosevelt U. v. Mayfair Constr. Co.*, 331 N.E.2d 835, 845-846 (Ill. App. 1975). In this case one provision made an architect's decisions subject to arbitration and another provision stated the architect's decision was final and conclusive, see M.H. Sam Jacobson, "A Checklist for Drafting Good Contracts" (2008) 5 J. ALWD 79-177.



ment to commit a crime or turn out to be so detrimental to one side that a party in their full mind would never have agreed to it, contracts become unenforceable. Nonetheless, apart from relatively strict rules for formation, invalidation and enforceability of contracts, much freedom is provided to the drafter.

A third source providing guidance to lawyers' in their contract design tasks is legal contract theory. Legal contract theorists have discussed the roles of lawyers as legal advisors of their clients and as influencers of contract design. Some authors have focused on the role of lawyers as contract makers, and many others have written books on how lawyers ought to negotiate or draft a solid contract. According to Ian MacNeil, the largest single segment of the business of the American lawyer is planning contractual transactions and relations (MacNeil 1975; MacNeil & Gudel 2001). In this literature, the primary tasks of transaction lawyers are identified as advising, documenting, negotiating and processing (Coates 2012). The language and terms of the contract in the more complex transactions discussed in this article are mulled over; language is suggested, drafted, modified and re-negotiated. Ronald Gilson introduced the term «transaction-cost engineers» for lawyers who efficiently add value to their clients and provide for well-designed contracts (Gilson 1984).

The literature also includes «how-to» books for lawyers, writings on good lawyering, contract drafting guides, and popular literature explaining what lawyers do and why (Chomsky & Landsman 2000; Gold & Bubela 2007; Stark 2007). Along with standard forms that have been developed for specific industries or by law firms, this literature probably exerts the strongest influence on how contracts get written. It finds application in standard contracts used in house by law firms, is made available via contract databases, or is built into the products of industry standards setting, such as the contracts developed by the American Institute of Architects. When making contracts from scratch some authors suggest using a checklist to help the drafter to be more efficient and avoid reinventing the wheel each time (Jacobson 2008).

Other authors go beyond the strictly legal aspects of contracts and champion for good writing and for tailoring contracts to the client's specific business. In order to live up to the duties of drafting adequate contracts, these authors stipulate that in addition to good legal knowledge, clear organization and good writing abilities are required in order to tailor a contract to the specific circumstances (Jacobson 2008). Usability and clarity are criteria by which to evaluate contracts. A contract should also withstand the test of a «bad faith» reading or a hostile audience.



Finally, it is advised to review the contract on a regular basis to be certain it continues to meet the needs of parties. Here, the lawyer who is receptive may consider implementing terms that help the business side to achieve its goals. The focus is, however, mostly on writing clear terms, and fulfilling the typical requirements of an enforceable contract.

Thus, we can conclude that the drafters of contracts are encouraged to primarily look to heed the objectives of the parties involved while protecting the interests of their client at the same time (Masten 2000). In doing so, the drafter will try to provide for all contingencies by predicting a series of outcomes. Each contract is unique and involves specific concerns, but it also involves many common requirements and considerations. Some clear design directions are given in books, and form contracts are common, even for highly complex transactions (Gulati & Scott 2012).

The fourth type of reference points lawyers rely on in their contract design work consists of their personal views on what contracts should provide. There are different schools of thought here. Where one group of lawyers seems to focus uniquely on giving their clients the best possible legal cover, others go a step further in designing contracts and also place a high value on goal alignment. The first group likely focuses on risk allocation and indemnities.<sup>8</sup> The latter group will see the creation of a mechanism that facilitates cooperation not conflict, as the purpose of contract negotiations. Ian MacNeil describes this latter concept as contract planning (MacNeil 1975). The first group of lawyers will tend to take a one-sided perspective and focus almost exclusively on ways to allocate risk away from the client. The latter group is most likely to consider the object of the deal as part of their design efforts. MacNeil describes the planning job as establishing a framework for handling unplanned aspects of the relationship. Two processes are essential to such contract planning: determining the parties' goals along as well as the related costs of their attainment. This approach to contract design includes identifying clients' explicit and implicit goals and the risks they are willing to assume.<sup>9</sup> The contract that results from these considerations will provide for procedures to deal with those risks.

Based on this review of the guidelines and rules that apply to contract drafting, one can conclude that rules governing the contract drafting

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8. Empirical studies support this by showing that the time spent on negotiating contracts is mostly spent on terms in these areas.

9. MacNeil (1975) (The first category being goals to be included in the contract and the second category to develop a good understanding of the clients' way of doing business).

process lead to the development of instruments that one-sidedly serve the enforcement task of contracts. This role of the contract also appears to be the dominant view and practice among lawyers. Few concrete incentives or practicable suggestions are available for lawyers to call upon in order to draft contracts that fulfill the task of actively facilitating cooperation via contracts. In all likelihood, the absence of this practice can be attributed to a lack of legal incentives and to the fact that lawyers simply do not see the framing and facilitating or cooperation as their task. It is not what they are paid to do or to be. Above all, any diversion from the current practices bring with it risks and potential push-back. Whether a lawyer is inclined to incorporate provisions meant to organize cooperation largely depends on his personal views – whether he perceives the contract solely as a transactional and protective instrument or has a broader appreciation of the contract's ability to sustain goal-focused cooperation. As it is, only a minority of those lawyers who feel personally compelled to write cooperative contracts may do so, but there is little that drives lawyers to make such an approach the standard (Levine 2002).

Two additional factors complicate maintaining a cooperative approach in contract design. First, contract drafting is a process undertaken by lawyers on *both* sides. So, if the other side is more tradition bound or conservative, the cooperative terms may be the first ones to be eliminated in the drafting process. Second, and more importantly, often-times, clients share their lawyers' narrow views of contracts and fail to see the opportunities to implement cooperative mechanisms. As the value of having such contracts may be underestimated, parties may instead opt for standardized contract terms.<sup>10</sup> Supporting and integrating such cooperative terms demands a real willingness and determination.

Should we then simply give up on contracts as cooperation devices and hope that the non-contractual dimensions, often the core of why the parties have established a relationship, will manage to work themselves out, even as relationships grow more complex? The earlier research on the role and effects of contracts suggests that maintaining the status quo may be the best approach. More recent research is more optimistic with respect to the future of contracts as instruments that frame and facilitate cooperation. Those studies indicate we should set aside those conclusions that push against the idea that contracts cannot be designed to foster cooperation, or that other mechanisms are superior. Empirical evidence suggests that a contract complements such non-contractual mechanisms and may even fulfill a positive role in need to enable coop-

10. See Triantis (2013) on the tendency to opt for standard contracts as cost reduction measure, and the concern of clients of being 'over-lawyered'.

eration. Some have studied this combination and support that these mechanisms (contractual and non-contractual) are in fact complementary and not mutually exclusive. Further supportive, a number of authors have infused a level of creativity and see it as their mission to design contracts that help both in relationship planning and facilitating cooperation (Levine 2002).

This little shift towards considering and designing contracts that fulfill this dual purpose can open lawyers to the idea of helping contract parties to design contracts that better serve their users. It can be the start of nudging lawyers to better serve their clients' relationship and cooperative needs. The evolving and emerging interplay of contract parties is presenting a framework that may convince lawyers that including cooperative terms in contracts is not only attractive and feasible, but necessary as well.

## **II. LESSONS FROM THEORY AND PRACTICE – ABOUT DRIVERS OF CONTRACTUAL BEHAVIOR**

In exploring how to integrate non-contractual mechanisms into contract design, we first need to understand the interplay between contracts and the other factors that influence behavior.

### **A. How to trigger contractual innovation**

Innovation arises as a result of 'shocks to the system'; these shocks be brought about by learning or as a result of clients requesting new or modified services. For instance, a new law is passed, changing what is required of parties, or a court decides to read into a typical contract clause something different than other courts before it. Lawyers generally respond by adjusting their clients' contracts. Very few lawyers are inclined to spontaneously tinker with the mechanics or objectives of contracts. So, they need to be nudged to explore new avenues. Perhaps the only motivating imperative would be a direct request from a client to change a contract or provide for something specific modification or innovation. What we can surmise from the foregoing and from the current professional practice is that the chance that cooperative contracts will spontaneously result is slim. Even with the tensions and discontinuities driven by the assessable need for contract innovation that is matched to innovations in business needs and strategy, in the short term, this is not something that holds priority for lawyers. The need for contracts that nurture cooperation may be evident, but in practice, there may be insufficient how-to knowledge outside of a few cutting edge sectors.

The ensuing question becomes how to trigger the type of contractual innovation that will lead to more cooperative contracts, contracts that take into account non-contractual dynamics. Lawyers may need a gentle push to be motivated to explore a workable strategy for practicing this approach. Foster a new contracting approach necessitates a better understanding of contracting behavior, its dynamics, and the undermining effects of our current system. A brief discussion can furnish insight into how different norms impact behavior and affect the achievement of contract goals. It can also show how tensions can arise as these norms compete with each other.

The potential practical benefits of having contracts that support cooperation, along with the theoretical basis for their potential, underscore the need to examine functional cooperative contract design more closely. An examination of the literature focusing on contractual behavior provides some direction.

## **B. Contractual behavior**

The design of most contracts seems to be based on a misconception or an oversimplification of how they influence behavior. They appear to be written in somewhat of a legal theoretical vacuum, as if their substance drives all parties' decisions. This position or approach brings with it the assumption that the contract 'controls' parties' behavior. To that end, parties' legal obligations constitute the framework of the contract. Clearly, reality is different. People's inclinations and behaviors are not the result of the language of the contract (Simonin 1997). In practice, real, tangible rivalry between informal and formal mechanisms can be found in projects, where informal rules may be pushed aside by the contract or contracts may push against informal rules of cooperation (Kamminga 2015).

These tensions between governance mechanisms can be illustrated as follows. For instance, in construction development projects, how a contractor in a contractual relationship behaves vis-à-vis the purchaser on the other side depends on several factors or types of motivational drivers. Consider the perspective of an entrepreneur; a first driver will be economic interests such as improving cash flow and garnering market share. A second set of drivers is embedded in social norms, best practices or customs of the construction sector, and in the informal agreements the contract parties' representatives make among themselves. A final set of rules that will guide a contractor in his cooperation with the other party are the legal norms laid down in the contract. The sum of these sets of norms – or behavioral drivers – together determines

how contract partners behave and how they judge others' behavior (Collins 1999).

Contractual behavior literature is a relatively small field that examines contracts as cooperation mechanisms. It is worthy of greater exploration for three reasons: First, there is the general assumption that contracts are ultimately meant to guide contract parties in their behavior towards each other and in their efforts to complete the contract goals. Second, the dissatisfaction with current contracts warrants a closer examination of optimized contract design. Third, this literature clearly shows both the importance of considering non-contractual dimensions when giving thought designing contracts and the dangers of failing to do so. The literature helps to illustrate and highlight the potentially adverse effects of contracts in relationship to other factors influencing the contracting parties' behavior. Also of importance, it clarifies how contracts can be used to their greatest benefit.

The contractual behavior literature is helpful in thinking through and analyzing the tensions that can arise between the norms set forth in contracts and other non-legal norms. These tensions are particularly problematic in complex long-term contracts, which are by nature incomplete and where other mechanisms are often desperately needed to keep projects on track. Scholars studying contractual behavior have investigated these norms and derived just how the tensions between norms may undermine cooperative behavior between clients and contractors and become a source of conflict and disappointing results.

The literature on contractual behavior identifies a number of drivers of behavior, ranging from the contract itself to social norms to economic incentives (Collins 1999). For instance, in construction contracting, these behavioral drivers consist largely of laws, regulations, and project management, but they also include more abstract structures such as culture, social norms, and customs unique to the industry (Williamson 2004). The argument is that behavior of contractual parties is influenced by the sum of the various normative structures that apply.

A rivalry between the norms can be derived from this literature. Collins (and others) investigates these norms and derives how the rivalry between them may undermine cooperative behavior between parties, becoming a source of conflict that trigger disappointing results. These findings are in line with the experience, in practice, of contract drafting and with what is suggested through interviews with people regarding their experience with contracts (IIACM 2011).

Currently, contract drafters try to reinforce behavior that is in line with the contract by providing one, the other, or both of the following: economic bonuses for living up to the contract and economic penalties for failure to comply with the contract (Bajari & Tadelis 2001). This reward-punishment feature may correct some of the tendencies that can go against the contract, but it can neither manage nor eliminate all. For instance, a construction contract may appeal to some economic drivers felt by a supplier of goods. Examples are liquidated damage clauses (penalties for being late) or savings-sharing clauses (bonuses for saving costs) that speak to the economic level. However, it's hit and miss as some but not all economic drivers will be considered in contracts or are not sufficiently appealing to really steer behavior. Even with the inclusion of these drivers in the contract, the social norms and best practices that parties develop over time are also not likely to be specified in the contract document. So, as soon as a party decides not to follow through on the terms of the agreement, resulting either from economic or relational reasons, the contract loses its effectiveness – often despite the bonuses and penalties. Breaking a contractual promise and risking legal consequences can be a more attractive option, particularly when legal enforcement is costly, when the survival of a company is at stake, or when social norms suggest a breach of the contract, especially where the relationship has reached an impasse and trust is damaged.

Not only does having an enforceable contract present limits, the contract may lead to unwanted side-effects by interfering with the positive effects of economic and relational norms, resulting in missed opportunities (Poppo & Zenger 2002).

Again, tension between these norms would not be a problem if the circumstances were such that parties could simply be forced to do what the contract stipulates. That would make the contract the dominant rule set and the main driver of contractual behavior. Unfortunately, complex contracts are limited in their ability to effectively enforce behavior for the variety of reasons referenced above (Crocker & Reynolds 1993). As a consequence, the contract is, on paper, the primary regulatory instrument, but, because it ignores the other dimensions, it does not provide a solution. As a result, different rules or norms enter into application in the contractual relationship between the parties. These non-contract rules drive the parties' behavior and may conflict with each other.

The existence of competition between various sets of rules is particularly relevant from the cooperation perspective taken in this article. These rule sets can be at the basis of a variety of contract management issues such as process problems and relationship issues (misunder-

standings, lack of cooperation, poor communication, and conflict). Those issues are problematic in a number of ways. First of all, when one party lives by one set of rules and the other by a different set a likely mismatch in contractual behavior can arise and tensions are the result. Second, having different views on which set of rules should apply directly undermines the process of coordination and interaction, an essential success factor in long-term business relationships.

This analysis suggests that there may be a better approach to writing contracts, one that does not proceed by building them almost entirely with control type provisions while ignoring the non-contractual mechanisms. The general response to incomplete contracts or correcting behavior has not resolved this tension. Neither adding incentives to strengthen contractual enforceability nor simply relying on informal mechanisms to carry cooperation process provides much certainty to parties involved in long-term agreements. This absence of both cooperative contract design and effective behavior incentives is becoming particularly impeding in an ever more complex and specialized economy, where parties are often forced to join forces, enter into partnerships or joint ventures. Sooner or later, the normative systems will interfere with each other. A more promising approach, it would appear, is to try to plan for better coordination between parties and assign non-contractual norms a place in the contractual framework.

### **III. DESIGNING THREE DIMENSIONAL CONTRACTS**

In this section I will take a somewhat different approach to contract design. Instead of taking the more traditional approach starting at a 'standard contract' and tweaking it, I propose an approach that first diagnoses what the specific contractual relationship needs, what the likely dynamic will be, and what type of design best fits that situation.

Today's contracts tend to artificially reduce the complexity of associations and social relations. Such an oversimplification of reality, however, has its downsides, as we have seen – ignoring other normative structures can become a threat to the coordination process. As contract parties also rely on other frames of reference to decide what actions to take and how to judge the other's behavior, the contract can undermine its own capacity to guide parties effectively and may disrupt cooperation. In other words, the purely contractual perspective ignores much of the context in which the agreement was made, how it fits into the ongoing relationship, how it affects others, and how it impacts sentiments of trust and loyalty. The only other solution for improving contracts so that they facilitate cooperation and deal with tensions between normative frame-

works is to design contracts that take these other dimensions into account.

#### **A. Inclusive contracts for a modern contractual environment**

The presence of other normative systems may be disturbing from the ideal legal perspective, but they are often useful from the perspective of cooperation, particularly in complex endeavors where contracts are almost by default incomplete and where economic stakes are high. In such contexts, these other norms may be helpful; their inclusion can serve to fill in the blanks. So instead of reasoning them away, drafters may want to learn about them and embrace them to make their contracts more effective, more organic and flexible, more likely to endure the inevitable unexpected. Understanding the dynamic is the first step in innovating in the practice of contract writing and re-engineer its scope and power.

The starting point for the proposed approach is to take the contract as just one of several dimensions of contractual relationships. Analyzing the relational, economic, and legal dimension of the relationship as well as both parties' preferences helps to anticipate the dynamic and what parties want to achieve. The contract can be designed accordingly and become the platform that ties the elements of the various normative frameworks together.

As discussed, these other normative frameworks may actually support parties' motivation to cooperate, increase their positive perception of the relationship with the other, reduce the likelihood of defection, and strengthen the level of trust, leading to further cooperative behavior, such as open communication (Ryall & Sampson 2003; Kamminga 2008). Adversely counterbalancing these factors, as contracts sometimes do, may result in distrust and get in the way of the kind of open exchange of ideas and visions essential to cooperation and necessary for achieving contractual goals (Macaulay 1963, Larson 1995; Dyer & Singh 1998).

Moreover, integrating and accounting for the economic and relational norms often assure the flexibility needed to get projects done, a flexibility that is missing in the contractual norms. The contractual framework is, by nature, the most rigid dimension and potentially the most adversarial of the three. Unlike the strictly legal approach, the relational and economic frameworks introduce structures that allow for compromise, which can supply to the cooperation and flexibility that contractual endeavors often require to survive and succeed.



Understanding this dynamic and knowing how to apply and integrate it can help drafters design better contracts. To be able to identify whether tensions between governance mechanisms exist and whether they may become a cause of a breakdown of cooperation, one needs to be able to understand the dynamic between the normative frameworks. One can then assess the discrepancies between norm sets. Having a better understanding of the relationship between these rule sets may lay the groundwork for more integrative, self-sustaining contracts.

#### **B. Understanding the dynamic between dimensions of contractual relationships**

Contract behavior literature provides a useful description of the types of norms at play and which may conflict with each other. Three dimensions can be distinguished: the business relationship dimension, the economic deal dimension, and the contract dimension (Collins 1999). They each present a certain set of norms.

The business relationship entails the evolving relationship that is built during and as a result of the series of transactions that necessitate the contract. This relationship gets established during enquiries, discussions of plans, and the deliberation of possible problems. It may be a new relationship, but often, there will be already some existing or ongoing relationship preceding parties' decision to enter into a deal. Business lunches and other informal interactions sustain it. The main criterion by which to evaluate or assess the quality of the relationship is trust. This relationship generates trust, which encourages parties to enter into transactions in the first place (Gulati 1995; Macaulay 1963; Saxton 1997). It thrives on the establishment and preservation of trust. The normative framework that supports it includes customary standards of trade, but it also includes the way of working that is unique to the parties' current relationship and other factors established along the way. Actions evaluated within the framework tend to be categorized as either demonstrative of trustworthiness or the opposite (Collins, 1999). Contractual behavior is evaluated by how the parties' actions sustain or subvert the bonds of trust (Ring & Van de Ven 1994; Gulati 1995).

The economic dimension is largely defined by the attractiveness of the deal or agreement between the parties. Reciprocal obligations are created, and the economic incentives and non-legal sanctions are established. The main criterion here is economic rationality; actions are assessed from the perspective of economic self-interest. Both short and long term economic interests are considered in assessing contractual behavior. The key measurements concern the price or costs of perfor-

mance in relation to the value of the expected benefits. Contractual performance is required only when the benefits exceed the costs of default. From this perspective, incurring a penalty may be deemed rational. It is important to note that acting in self-interest in the short-term is unlikely to lead to cooperative conduct in the long run (Granovetter 1985; Ring & Van de Ven 1992).

The third dimension is the contract itself. The formal agreement is another frame of reference by which to judge whether the other party has defaulted or cheated. The rules instituted by the contract are the main criterion for making such assessments. The contract language describes how the contract framework 'thinks about' (interprets) the relationship between the parties. It emphasizes the autonomous, un-situated obligations constituted by the formal agreement. The way in which the contract views disputes is a normative framework, which isolates the transaction from its economic and social context. It treats the obligations undertaken as absolute responsibilities, firm commitments, which cannot be revised except through the process of revising the contract itself (Collins 1999). Parties may decide to iron out the details of a potentially divisive issue in a formal way for the purposes of clarifying the problem and determining the allocation of risks and liabilities in advance. This may even be done using terms that might not be enforceable in a court of law.

Taken together, these three dimensions, derived from these normative frameworks, provide guidelines that parties use to select and manage their own behavior. These same rules also determine the way in which one party will judge the behavior of the other party. These dimensions and the normative frameworks that come with them are applied within the context of a particular contractual relationship and within the context of the history of the parties' prior relationship. They are grounded in law and personal relationships, and they are important in the construction of market relations. The parties can think and converse about their relationship in different ways. The manner in which they proceed will depend on which normative framework is providing the dominant points of reference.

Tensions can arise when the norms that result from the relational and economic dimensions invoke obligations that go contrary to the norms laid down in the contract. When contractual thinking intersects with relational and economic norms, each normative structure may provide opposing valuations of conduct, and as a result, conflict and competition arise. The non-contractual dimensions may exclude contractual thinking and treat it as dysfunctional, as lacking the appropriate understanding of events and relations (Collins 1999).

These tensions also lead to dilemmas for the managers involved in choosing which rules take priority. They struggle with the choices supposed of blindly following the contract, looking for opportunities to be creative within the terms of the contract, doing what is in the best interest of the company, or adhering to their own set of rules in day-to-day operations? The type of rule set that will be chosen depends on the mandates given to agents, as well as those agents' personal philosophies regarding norms that ought to apply in contractual relationships.<sup>3</sup>

This variety of applicable rules can lead to complications at the organizational level. One can imagine different norm sets being selected and applied, depending on the nature of the prevailing circumstances. Almost inevitably, competing normative frameworks will be applied by different departments within the same organization. Discussions could, for example, arise between the legal department that drafted a contract applying a strictly contractual framework and the department involved in contract management, for whom the relationship may be at least as important as the contract document.

Furthermore, parties may choose different, dominant norm sets and still tensions over the weight of individual elements of understanding may arise. Such a scenario could arise if both parties rely on the contract as the dominant normative structure. That, of course, is the ideal situation from a lawyer's perspective. In a second potential scenario, they both use one of the non-legal frameworks as the dominant normative structure – the norms deriving from the business relation or economics of the deal dimension. This second scenario creates an unstable situation where parties may be forced to revert to the contract to resolve differences, requiring a third party's involvement. In a third potential scenario, the purchasing party may use the contract for guidance, while the supplier applies the norms inherent in the relation or economic deal dimension.

In any of these potential situations, problems appear when disagreement arises, since each party is judging the other's behavior based on different points of reference. For example, the purchaser may find that the supplier is not following the procedures as laid out in the contract. The supplier justifies this change relative to the contract by referring to a give-and-take mechanism that the parties developed over time. Such a mechanism allows for more flexibility in dealing with minor schedule changes, as both parties may need to ask for changes at different points in time. By evaluating parties' contractual behavior using an assessment tool, such discrepancies may be identified – ideally ahead of contract design. By taking the time to conduct an analysis of contractual drivers

and parties' preferences, parties can anticipate potential problems and agree on a mechanism to address them.

### **C. A framework for contract design – assessing tensions and drafting contracts**

Theory that examines the different dimensions of contractual behavior and empirics about contract success could be of use to designers. It would be beneficial to get a good grasp of the different contractual dimensions, which then enables drafters to attempt to align these dimensions. With this foundation, applying a variety of norms for the purpose of evaluating the same issue would not represent a source of tensions between parties or in their own organizations. Instead, if well aligned and well thought through, these norms may reinforce each other.

In the next two parts, I propose a two-step diagnose-and-design approach. It may be used for detecting tensions between norms upfront and addressing them. In the following section, I discuss the idea of diagnosing whether contractual relations are exposed to actual or potential derailment of the cooperation process and what to pay particular attention to. Following from the discussion of assessment or diagnosis, I propose some guidelines for integrating the collected information about the identified tensions into designing the contractual environment for long-term business relations.

#### **1. *Assessing potential tensions between formal and informal structures***

A feasible method for analyzing the influencers of contractual behavior would need to focus on the following five elements: (1) identifying the different norm sets at play; (2) determining whether parties are in agreement about the applicable norm set and about the actual norms they set forth; (3) identifying whether tensions between these sets may arise, and, if so, the nature of the tensions; (4) identifying the dominant norm set at different points in time; and (5) determining if disruptive shifts between norm sets are to be expected.

Step one entails identifying the norms that parties are likely to apply. The dimensions of the contractual relationship as described earlier in some detail are the relationship dimension, the deal dimension, and the contract dimension. Each dimension has its own standard norms. These norms may differ and result in different perceptions on what the relationship is all about. For instance, from a contract perspec-

tive the relationship between the contract parties is mostly a set of rights both parties have and duties they owe each other. From a relationship dimension perspective it is all about how the relationship most optimally functions based on the norms that represent acceptable behavior in the specific sector and the routines parties develop amongst each other. That determines what is acceptable, expected and 'fair'. Someone looking at the economic dimension of a relationship will perceive the benefits parties could derive from the particular project parties embark upon and the costs thereof as main drivers of ones actions. Similarly, the normative perspective one takes determines whether the contract partners' behavior will be evaluated as positive or negative, and knowing what norm set takes priority may help predict the others behavior. After all, the choice of norm set also determines the parties' own decision-making, and the measures that will be used to take actions. What course of action saves the most costs? What reaps the most benefit? Or what is the best for the relationship in the long run?

The second step in assessing tensions is to explore whether parties are in agreement about the most important norms and the exact meaning of the agreed upon norms. It is necessary to determine if parties agree on the applicable normative framework and the norms it sets forth, and which norm should get priority in a certain situation in case they do not align.

The third step in the assessment is determining whether tensions between the normative structures exist, and if so, the nature of those tensions. Having multiple standards function in parallel means that the norms they set forth may collide and compete with each other. Certain behavior can, for instance, be in accordance with one set of norms (e.g. the contract) and interfere with another (e.g. the economically most beneficial course of action).

The fourth step is to identify the dominant normative framework that the parties are likely to apply at different points in their relationship – do contractual norms go above other norms, or is the relationship considered most important? All dimensions may be relevant, but one framework will often dominate at certain times. What are parties' preferences in this regard? The influence of the relationship norms in contractual relationships can at some point turn out to be stronger than the contract norms. This is evidenced by the presence of contractual behavior that is not justifiable by the contract – a purchaser may decide not to enforce his rights with regard to a planned delivery or a missed milestone but allow the supplier some flexibility to deliver shortly thereafter.

The fifth and final step in the assessment is determining whether there are disruptive shifts from one dominant norm set to the other occurring or expected. Sudden shifts in dominant normative orientation can, for instance, arise during a dispute. These shifts may go in different directions. For instance, a shift from the relationship as the dominant framework to a pure contractual approach may result in a move towards a more rigid negotiation approach, and away from a more flexible manner of dealing with changing circumstances. On the other hand, when trust levels are high between parties, the shift may go the other way – from a strictly contractual approach towards a more relational approach.

The shifts that occur away from the relationship dimension are obviously more problematic from a cooperation perspective. They may, for instance, happen when the contractual parties experience financial strain. For instance, in our example of the construction project, one can imagine that a relational approach to a more contractual or legal approach often occurs when losses are experienced on the side of contractors, when costs turn out much higher than anticipated, or when the contract was won at a price that results in thin or even non-existent margins. In addition, changes in preferences may lead to shifts. The contracting officer of the purchaser responsible for administering and oversight of the project may get worried about missing deadlines and request a stricter application of the contract. A strict interpretation and narrow reading of the contract's scope can lead to penalties. Shifts may also occur when compromise seems not to work anymore, and a strict contractual interpretation appears to be the only option.

Adverse circumstances or the anticipation of unwanted outcomes may drive both parties away from a more cooperative and flexible approach towards a more rigid, contract driven stance. Particularly, the shift from a relational to an economic or a contractual framework can foster an adversarial atmosphere. Such a shift in the frame of reference easily hardens the relationship and leads to distrust, which may deteriorate cooperation even further (Macaulay 1963; Dyer & Singh 1998). Understanding these dynamics helps understand how contractual relationships evolve and anticipate the hurdles along the way, the first step in trying to capture them in contracts, working with them instead of against them.

## ***2. Integrating the dimensions in contract design***

Collecting information about the variety of applicable norms, the likely dynamic, and the parties' preferences is analogous to having all pieces of the puzzle. The next step, then, is trying to assemble the puzzle

– merging the norms to better manage the cooperation process. Design principles may be formulated to guide that process.

Parties, by now, should have realized that there are multiple norm sets driving contractual behavior. The occurrence of this variety also requires accepting that parties may shift between these rule sets at times throughout the lifetime of the contractual relationship. An approach that accounts for this tendency to shift may keep parties out of the «trenches», keep them from retreating to legal positions. This approach to contract design ideally facilitates that process and enables parties to maintain or loop back to cooperative behavior more easily.

Once sufficient insight is obtained regarding potential tensions between norms sets, the actual contract design effort becomes focused on integrating the dimensions, along with their norms, in a constructive and coherent contractual structure. The objective to embrace the different dimensions of contractual behavior, taking into account the parties preferences with regard to the norm sets, and providing for smooth transitions from one normative framework to another. Its application requires a practicable strategy for integrating the different norm sets.

Integrating norms may help in dealing with the instability of separate norm structures. By simply anticipating the application of the different norms, one can foresee where they may compete and anticipate when shifts in the dominant dimension may occur. Integrating various dimensions into the contract may help overcome the drawbacks of the individual dimensions, while also allowing for the oversight and legal enforcement of obligations. Balancing these elements in practice may require enforcing certain aspects and diminishing those others that tend to undermine cooperation between parties.

The first step in integrating the norm sets is to choose a dimension or platform. Of the three, the contract seems the most plausible and stable platform, the most malleable and controllable basis. It possesses all the advantages inherent in a contract, and it serves the functions of information carrier, risk allocator. If need be, it is legally enforceable, and contract law allows parties broad freedom to agree on both content and process. In supplementing these core legal features of the contract, one can import other norms into it.

Parties may initially want to focus on filling in the essentials of the contract. These essentials consist of the parts that define and address the basic substance of the project – the specifications, the conditions, the scope of project, and the timeframe for the deliverables. The establish-

ment of these elements provides a structure into which the normative structures can then be integrated.

The next step could consist of defining the rules governing the parties' interactions. Apart from documenting the contract essentials, a contract can empower parties to create their own distinct understanding of the rules that should govern their relationship. A contract can contain detailed specifications of the normative standards that should apply to the various aspects of the relationship. There is room to adjust to what both parties like best and prefer to establish as the rules governing their relationship. These elements of contracts concern aspects that influence cooperation – the interaction and coordination between parties – and represent points where ideas derived from the other frameworks can be integrated. Parties may use aspects from the various norm sets to determine how they will proceed in their coordination of efforts. They can brainstorm or otherwise determine where relational principles and norms are leading, on which items the economic norms are likely to be the most useful as guiding principles, and with regard to information exchange about risks and anticipated changes, what norms they agree on. The parties can also devise rewards for speedy project delivery, decide which incentives best meet the contractors and agencies' interests, and agree on workable processes to deal with change orders rapidly and at a low cost.

The next step would be choosing the best practices that best support a cooperative relationship. Experiences with cooperative principles and studies, for instance, can provide a good sense of the most common human tendencies and traits with regard to information exchange, the most acceptable social norms and most common triggers of economic behavior with regard to penalties and responses to unexpected events. The selection may be based on these insights on the drivers of cooperation.

The next step should be to incorporate the rules governing the contractual relationship into the contract. Regular contract evaluation allows parties to refine, adapt, and incorporate the aspects of the three normative frameworks that both parties further agree on to guide their relationship.

These proposed steps to identifying potential tensions and attempting to integrate informal governance structures in the overall contract design comprise only one example of how lawyers may claim a more constructive role in helping contract parties actually achieve their goals without the intrusion of unresolvable conflict.



#### IV. IMPLEMENTING NEW CONTRACTING STRATEGIES IN A CHANGING LEGAL ENVIRONMENT

Another challenge in the implementation of this cooperative approach in legal practice is getting lawyers to actually design these types of contracts. This final section discusses the obstacles faced when attempting to integrate this approach into contracting. A return to the difficulties of contract innovation and options to possibly overcome them are discussed below.


##### A. Why lawyers would embrace designing contracts that support cooperation

The foregoing may convince those lawyers who strongly believe a contract serves to plan the relationship, but will other lawyers that see the role of contracts more limited also be sufficiently enticed to embrace the role of incubating cooperation? Clearly, there are barriers to implementation similar to those that slow down innovation, but I believe some counterarguments can be presented that may encourage lawyers to embrace such a role after all.

It is a fact of life that in many countries lawyers are the dominant force when it comes to contract design, and it's also the case that they tend to be hesitant when it comes to innovation.<sup>11</sup> Law, after all derives much of its structure and force from longstanding traditions; slow change or no change may equal stability. It comes as no surprise that obstacles to contract innovation present themselves in lawyers' views of their priorities and roles, in the risks associated with changes in contracting strategy, and in the problem of so-called 'stickiness' of contracts (Preston & McCann 2012). Some have also pointed out the absence of an ability to benefit from contract innovation through securing intellectual property rights (S) incentivizes the very impetus to innovate. Again, others have argued law firm dynamics get in the way (Gulati & Scott 2011; Triantis 2013). (M)ultiple factors are slowing down innovation in contract design. The lack of incentive to innovate only partly explains why lawyers do not draft more cooperative contracts. Having lawyers involved is of course not all bad. A benefit is that clients get the careful review of contracts and risk management that only lawyers can provide. A downside is that innovation in contracting easily gets drowned out by lawyers that see contract innovation as too much of a risk.

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11. Depending on the country and the experience of purchasers these roles may vary. But oftentimes approval of these terms will lie with an external lawyer.

Lawyers are trained to design certain types of contracts and innovation is associated with legal risk. In these circumstances, contracts are mostly drafted with a focus on their role of underpinning the parties' commitment to their obligations. This function remains critically important since the complexity of large-scale  projects can provide many opportunities and temptations for opportunistic behavior (Williamson 2002). Lawyers are incentivized to focus attention on defining the objective (effort or task at hand, quality of the goods or service), the payment arrangements, and the parties' legal rights and duties related to risk distribution, responsibilities, and applicable law. Lawyers try to make sure their clients get what they want by negotiating a legally enforceable, valid agreement that states the duties and rights of both parties and allocates risks optimally. This approach may lead to a shift of risk to the other side, but it does not foster cooperative contracting.

Second, lawyers by nature tend to be traditionalists – risk averse and not likely inclined to try out new types of contracts. The reasons include professional liability and uncertainty with respect to how courts may deal with new kinds of contract clauses.

Third, results of recent studies indicate that contracts are “sticky” (Gulati & Scott 2012), particularly standard term contracts. A standard contract can, once made, stay unchanged for generations. This is a common, important dynamic that can hold back innovation. It also undermines the quality and effectiveness of contracts.

The empirical literature on drafting habits also points out that lawyers, in their role as contract engineers, rarely make contracts from scratch, but rather adapt and assemble standard contracts either developed by their law firm, or based on trade standards designed by associations.<sup>12</sup> In fact, findings suggest that very little time seems to go into the drafting of these contracts (three and a half minutes according to Gulati & Scott) even when it comes to high stake business contracts (Gulati & Scott 2012). What may be suggested by these findings is that some of the reluctance to draft innovatively in response to shifting client needs may be rooted in the fact that many lawyers actually perform very little drafting.

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12. Gulati and Scott refer to the notion of contract routines, lawyers are working with a complex set of contractual structures and no one may completely understand the relationship between certain provisions and the larger contractual structure. Out of a fear of upsetting other contractual provisions unwittingly they tend to refrain from making any alternations, Gulati & Scott 2012 at pp. 38, 39.

In practice, the rational motivations and objectives are often not translated in improved contract design (Gulati & Scott 2012; Ben-Shahar & Pottow 2006; Choi & Gulati 2006). As a result, imprecise contract language remains present in contracts because changing it brings along the risk that a court might adopt a different and destabilizing interpretation of the term. This lack of motivation to change may also apply to tensions between formal contracts and informal governance mechanisms. Empirical studies also identify a general trend of reluctance to change contracts, rooted partially in agency problems (Korobkin 1998). So, lawyers may tend to refrain from optimizing standard form contracts even when that would benefit parties. This literature suggests that the amount of care put into the actual drafting of contracts is not optimal – let alone new contract optimizations being added – and that tensions may not be discovered for a long time.


Compounding these challenges, contract negotiators tend to spend most time negotiating over terms that address consequences of claims, and do not give much attention to terms that business managers find important – the terms dealing with the management of the relationship and changes which may prevent claims (IACCM 2011).<sup>13</sup> In other words, tensions may lie dormant for years in contracts, and terms addressing coordination issues can get less attention than the typical legal terms.


So how can we trigger change? Significant changes and innovation in contract design do happen, but they often appear to be the result of external forces. This implies that exogenous factors may trigger change, rather than internal ‘best-term-survives’ dynamics (Gulati & Scott 2012). Innovation literature suggests that so-called ‘shocks to the system’ lead to evaluation. Examples in the area of contracting are court decisions on the judicial interpretation of a contract term as we saw above, but change may also result from shifts in markets and the need to respond to new knowledge.<sup>14</sup>

The question arises whether such shocks to the system are currently happening and whether they are strong enough to overcome the obstacles that stand in the way of innovation. Some developments may


13. The International Association for Contract and Commercial Management collects information among contract negotiators from various industries about the most negotiated terms. At the top of the list: limitation of liability, indemnification, price related terms, scope and goals, liquidated damages, and payment clauses (IACCM 2013).


14. A more sudden shift in contracts may be the response to a shock causing changes in the legal landscape. It triggers or may force firms to innovate and respond to those changes, however, often this response is not instantaneous, Gulati & Scott (2012).

qualify. First, the changing demands of a lawyers' client may potentially push for more integrated contract design. Developments such as increasingly demanding and critical clients and other changes in the legal profession may require lawyers to come up with innovative contracts. This includes contracts that better foster cooperation and reduce the chance of conflicts and allow clients to really voice their preferences and concerns. If ward mechanisms for lawyers could be more results-based and based on the amount of disputes or uncertainty resulting from contracts as a factor taken into account, this may also lead to changes in contract design. Shifting from a document good enough to stand up in court to a document that tries to make collaboration go as smoothly as possible and without any disruption.


Second, what can further help make the difference are empowered clients who start to change what they ask from lawyers and become very specific about it – clients who question the assumption that a contract is a necessary evil and instead consider it as an opportunity to build in certain cooperative behavior. These clients will ask for a different type of contract, not the usual safety net or protection against the other side, not a mechanism for allocating blame or facilitating clean-up after relationship failure. These traditional tasks of the contract, all of which anticipate the non-achievement of parties' goals, can be managed and avoided by making cooperation attractive.  contract as a threat composed of legal repercussions does not necessarily present an incentive to cooperate.


What also will be important is an increased awareness among clients that failure to use contracts to facilitate cooperation is a missed opportunity in the long run. It means that users will need to be creative in finding opportunities to cooperate and find solutions to coordination problems that do not involve the contract. As soon as using the contract seems to serve the interests of a party better, or if it is too complex to manage, the contract is back on the table and provides little guidance apart from a mediation clause or a procedure for dealing with changes.

As an encouraging sign, some sectors may be spearheading change, as they are more inclined to asking for innovation and require it more than others. Early adapters can often be found in industries that are innovative and used to operating in uncertain environments. e areas include as R&D collaboration in the pharmaceutical industry, various strategic alliances, and projects in the construction sector (Kamminga 2008; Furlotti & Grandori 2010; Gilson *et al.* 2010). In these industries, parties are aware of the need to adapt to changing circum-

stances and are constantly reminded of the complex interdependence, technical resources, innovation, and expense required to develop new products 

## CONCLUSION

In the previous sections, the central claim has been that, despite obvious problems with contracts as cooperation mechanisms, there has been little contract innovation focused on making contracts better in that respect. Innovation still receives little attention in contract design. 

 Lawyers, as the primary drafters of contracts, can change this fact, but they must have sufficient incentive to do so. Lawyers may not be prone to change in the absence of outside triggers. It appears that a fundamentally wrong assumption is still underlying most contract design efforts; namely, that contracts are governance mechanisms, which, if adequately and forcefully designed, will prevail and drown out other dynamics and drivers of contractual behavior such as social norms, economic incentives and self-interest, and trust dynamics. As a result contracts are of little help in establishing the type of cooperation management researchers have found essential in complex contractual relations.

This article advocates for a contracting approach that integrates these non-contractual drivers into contract design. Adapting an interdisciplinary contracting approach to contracting may be a way forward for lawyers who want to support their clients' achievement of the type of cooperation that empiricists have found essential for achieving contractual goals. In situations where parties cannot rely on a smoothly functioning legal environment, contracts may be of particular help by including or aligning with other governance structures.

Lawyers who step outside of the comfort zone of traditional contracts may start to provide their clients with both a stable contractual environment and a framework with which to integrate and align the reality of business endeavors. Lawyers who explore and address both aspects become lawyers who provide better value-for-money to their clients, avoid disputes more effectively, and contribute to necessary legal innovation.

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